Statement of Ronald D. Earl, General Manager & CEO, Illinois Municipal Electric Agency (IMEA) and Member of the Board of Directors of the Transmission Access Policy Study Group (TAPS)

Remarks to the Illinois Commerce Commission on FERC Standard Market Design Notice of Proposed Rulemaking

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I would like to thank the members of the Illinois Commerce Commission for the opportunity to offer remarks on the Standard Market Design (SMD) Notice of Proposed Rulemaking (NOPR or "SMD rulemaking") issued by the Federal Energy Regulatory Commission (FERC or "the Commission") on July 31, 2002.

I am the Chief Executive Officer of the Illinois Municipal Electric Agency, a municipal joint action agency serving 30 municipal electric systems in Illinois with their wholesale power needs. We deliver power into all three control areas of the major Illinois investor-owned utilities. As such we are uniquely concerned with the impact FERC's standard market design will have on our members and their customers.

IMEA is also a member of the TAPS group, which is an informal association of transmission-dependent electric utilities located in 34 states. TAPS members own generation and purchase a substantial amount of power and energy under a variety of wholesale contracts. They serve their member utilities and retail customers under long-term contracts and state law obligations to provide reliable service at reasonable cost. All TAPS members depend substantially on transmission owned and controlled by others in order to deliver their power on a reliable and economic basis to their customers.

Since its inception in 1989, TAPS has been an ardent advocate of the development of vigorously competitive wholesale electric markets. We have actively supported the creation of strong, independent regional transmission organizations (RTOs). TAPS commends the FERC for its resolve, since the passage of the Energy Policy Act of 1992 (EPAct), to achieve competitively neutral regional transmission systems that provide open, non-discriminatory access to all users. We particularly applaud FERC's decision in the SMD rulemaking to eliminate the pervasive discrimination that exists between bundled and unbundled transmission service.

A competitively neutral transmission grid is an essential condition for the creation and maintenance of competitive wholesale markets. FERC's efforts to move the industry into RTOs have run into many obstacles. This should surprise no one, since RTOs are specifically designed to take away the substantial competitive advantages that have been enjoyed by incumbent, vertically-integrated systems for years.

IMEA and TAPS further commend the Commission and, in particular, the leadership of Chairman Pat Wood, for issuing the SMD rulemaking, and for the Commission's commitment to the clear objectives underlying this rulemaking. FERC's goal is to once and for all eliminate undue discrimination in the provision of transmission service for all purposes, and to achieve vigorously competitive, transparent short-term energy markets for the benefit of consumers. The Commission's objectives are admirable and its dedication to consumer interests is clear. However, we believe that the challenge of achieving these objectives is monumental and we greatly fear the consequences of failure.

Like many others, we have significant concerns about the important details of the SMD proposal. We will be commenting on these concerns to the Commission. I will highlight several in this testimony.

Recent experience has taught us all how very difficult it will be to achieve and sustain truly competitive electric markets. We know today that it is a far more complex undertaking than the economists and others anticipated five years ago. We also know that the consequences of error can be disastrous.

Therefore, we will be urging FERC to take the time necessary to get it right. The SMD proposal is massive. FERC needs to move both cautiously and deliberately to finalize the rule, taking into account the legitimate concerns of many parties. Also, it is essential that FERC not waiver or compromise on fundamental principles such as RTO independence, rational RTO boundaries, and complete comparability of service. The ultimate objective must be just and reasonable electric rates for all wholesale purchasers, not deregulated prices simply for the sake of less regulation. If the result of restructuring markets is not lower prices and better service than the traditional cost-of-service model, restructuring is not worth the effort.

Despite the obvious obstacles and the extremely disheartening and unethical, if not illegal, behavior of a number of significant market participants that has become evident in the last year, we continue to believe that the introduction of more competition into the industry will benefit consumers. However, we believe that it will take tremendous regulatory resolve, vigilance, and courage to achieve and sustain competitive markets. We also caution that major problems will develop in the implementation of SMD if details are driven by a short-term market focus, without respecting the

fundamental principle that the ability of load-serving entities, large and small, to meet their obligations to customers with existing resources and future resources must be protected.

IMEA is also very concerned that two developments in our industry will end up defeating FERC's pro-competitive objectives, despite the best of intentions. It is very important for FERC to step back and recognize the realities of our changing industry.

First, in many places, our nation's transmission infrastructure is clearly inadequate to support competitive markets. Transmission construction is extremely difficult. It has been neglected by many utilities because a weak transmission system protects their local generation investments. Transmission congestion is increasing, and with congestion, opportunities to manipulate markets grow exponentially.

Second, concentration in the ownership and control of generation is increasing. Although the highly concentrated structure of many electric markets today is to a great degree attributable to the industry's roots as vertically-integrated franchised monopolists, the recent increase in concentration is primarily a result of the major shakeout occurring in the merchant sector. There are fewer and fewer, not more, competitors, and the beneficiaries of the shakeout will be the largest incumbent utilities whose market dominance can only grow as new market entrants fail or sell off assets. This means fewer sellers, less choice, and less competition. In addition, if Congress repeals the Public Utility Holding Company Act, we can expect a deluge of merger proposals that, if approved, will dramatically increase concentration.

SMD will not benefit consumers if the transmission system becomes increasingly congested, so that region-wide "non-pancaked" access exists on paper only, while in

reality, a customer's only choice is generation close to its load. SMD also will fail if, as a result of increasing concentration, very few supplier choices exist in fact. The combination of increased congestion and concentration is frightening. A very large market participant with generation located in a variety of places on a congested regional grid will be able to dispatch its resources to create congestion, and thereby increase its competitors' costs and create new opportunities for profits for itself. This is an invitation for manipulation that is hard to detect, and which can significantly harm consumers.

For these reasons, FERC's SMD rule must be carefully constructed to (i) ensure that needed new transmission infrastructure will be built in a timely fashion to give all customers reasonable access to competitive regional markets; and (ii) provide for comprehensive market monitoring and market power mitigation measures that will prevent manipulation of the market in new and inventive ways and, especially in areas where effective competitive will not exist any time soon, protect customers before, not after, they are harmed.

There are, of course, many issues related to the details of the SMD rulemaking. I would like to highlight three crucial elements that require clarification or change.

1. <u>Protection of Existing Transmission Rights.</u>

The SMD NOPR states that it is FERC's intention to provide market participants that have firm transmission rights today through ownership of facilities or by contract, with new, equivalent transmission rights under SMD. This is essential so that entities like IMEA and its members can continue to deliver power from their resources to their loads without a material change in reliability or cost.

IMEA has long-term, load-serving obligations. To meet these obligations, we have made major investments in generation, and significant power purchase commitments, that never could or would have been made without simultaneously obtaining transmission rights, or constructing transmission facilities, to be able to deliver these resources to their customers. For instance, IMEA bought a 62 MW share of a large coal-fired plant in Kentucky in 1990. To be able to make this purchase and finance the unit, we had to secure long-term transmission rights. Those rights are essential to the economic viability of our investment and to our continued ability to provide reliable service to our members and their customers. The municipal systems half million citizens will suffer severely if we do not receive rights under SMD that are, in fact, equivalent to our transmission rights today. This same issue exists for every TAPS member and for many other utilities, private, public and cooperative, that have invested in generation and made long-term purchase commitments to reliably serve customers, dependent upon related transmission delivery rights and investments.

The SMD NOPR states an intention to protect existing transmission rights. But we are very troubled by the fine print, which in many places suggests that we may end up with rights that are significantly less secure, less valuable, and shorter term. While we applaud FERC's stated principle, we are very concerned about its implementation.

Existing rights to transmit existing generation commitments to load must be honored. TAPS will be urging FERC to craft its final SMD rule, and the associated implementation details, to fully protect these existing transmission rights.

2. <u>Securing Long-Term Transmission Rights for New Resources.</u>

A second, very important priority is modifying the SMD proposal to clearly enable load-serving entities to obtain new, long-term transmission rights that will allow assured delivery of new resources to our loads without significant risk of congestion costs. My utility must build new generation. This is true for many other public power, cooperative, and investor-owned systems across the country. The simple fact is that we must meet our loads reliably, which requires long-term investments, long-term contract commitments, and long-term planning. Recent experience has shown that we cannot rely on the merchant sector and short-term markets for needed capacity.

IMEA's members' growth will require us to secure additional power supply resources later this decade. At this moment we are examining the options we have to provide wholesale power to our members over the coming years. Among the options is and ownership interest in one of a number of potential new base load facilities that may be built in Illinois or surrounding states. But if we cannot secure firm transmission rights to deliver the output from this project, we may not be able to secure the necessary financing. And that will expose our members and their customers to something they don't want - the uncertainty and volatility of the cyclical power market.

Unfortunately, the SMD proposal speaks in terms of securing future rights of one week, one month, one year, or perhaps, longer in duration. "Perhaps longer" is not good enough. TAPS members are not speculators. We cannot build plants with 30 to 50-year lives and issue debt that is amortized over 30 years, with only short-term delivery rights and congestion protection. We are willing to pay our fair share of the costs of the transmission needed to integrate new resources into the network and to deliver power from those resources to our loads on a reliable basis. But we are not willing to rely on

outbidding all other market participants in annual auctions for the transmission rights to secure delivery of long-term generation investments or power contracts.

In fact, IMEA was very progressive in converting all our members' to network integration transmission service under Order 888 open access transmission tariffs. We did so with the understanding that our transmission providers would be responsible for planning and building the necessary transmission capacity to meet our needs. We are fearful, and for good reason, that SMD as proposed by FERC will undue that compact.

We will be urging FERC to modify its SMD proposal to clearly provide that load-serving entities can designate new network resources dedicated to serving their loads and can obtain new, long-term transmission rights that match the life of those resources. The ICC should do likewise.

3. <u>Getting New Transmission Built.</u>

If the objectives of SMD are to be realized, it is essential that new transmission be built in a timely fashion. Congestion must become the exception, not the rule. We have a lot of catch up to do and it will not be easy. Transmission is a natural monopoly characterized by network economies and, in many cases, can be built only with the use of the public's power of eminent domain. Siting can be extremely difficult and delays are common. Siting authority rests in the states, rather than in FERC, which creates further difficulties in planning on a regional basis and meeting regional needs. For these reasons, simply relying on market signals to drive needed new transmission construction is not likely to work.

Unfortunately, FERC's SMD proposal states a strong preference for a "participant funding" mechanism for getting new transmission built. Participant funding is an

undefined and untested concept. It apparently presumes that individual market participants — generators and load-serving entities — will step up and pay for the construction of new lines in advance, despite long construction lead times and the changing nature of grid flows over time, in exchange for the rights to congestion revenues. This approach would provide existing generation with a significant competitive advantage over new generation.

We will seek to convince the FERC in the SMD proceeding not to place primary reliance on participant funding in order to achieve a robust grid. The Federal Power Act already contains the standards needed to guide FERC to the right result. Sections 205 and 206 require transmission rates to be just, reasonable, and not unduly discriminatory or preferential. To this fundamental pricing principle, EPAct added Section 212(a) to address the pricing of transmission service ordered under Section 211. Section 212(a), which the Commission has read into Sections 205 and 206, requires that transmission charges "promote the economically efficient transmission and generation of electricity." It also mandates that, "to the extent practicable, costs incurred in providing the wholesale transmission services, and properly allocable to the provision of such services, are recovered from the applicant for such order and not from a transmitting utility's existing wholesale, retail, and transmission customers."

We recognize that some state commissions have legitimate concerns about transmission construction driven by new generation built in one state to sell output into another state. Obviously, the customers where the generation is built should not be saddled with high transmission costs to subsidize long-distance deliveries elsewhere.

This problem can be dealt with effectively by the FERC with a rate design that assigns costs to both loads and generators based on cost causation and benefits received. Charges for transmission do not have to be borne solely by the load where the transmission facilities are located. TAPS generally supports an innovative rate design proposal recently made by the proposed TRANSLink Transmission Company in the Midwest. Under this concept, the costs of high voltage highway facilities would be shared among all load within a region and not be shouldered solely by loads in the particular state where a facility is located, and the costs of lower voltage local transmission facilities would be shared by loads and generation (including exporting generation) within the local area. This proposal is currently pending at FERC.

It is most important that new transmission be built promptly. Relying on participant funding is likely to lead to significant delays for a number of reasons. Most transmission lines have multiple purposes and provide simultaneous benefits to diverse parties, rather than to a single party or set of parties. In fact, to get approval of a new transmission line, it is often necessary to demonstrate multiple benefits and that the proposed line is the least-cost solution to meeting a variety of needs, including local voltage support, reliability under various contingencies, as well as improving access to economic sources of power. The multiple purposes of lines will create significant free rider problems: parties may be encouraged to wait and see if someone else will pay for a line, which will end up benefiting many. In addition, the beneficiaries of a network upgrade will change over time with changes in load, generation, and grid topography. Efficiency and cost-effectiveness will often require upgrades to be sized larger than is required for discreet, immediate needs of the particular market participant that would

fund an upgrade. As a result, under a participant funding regime, optimal improvements from a regional, long-term planning perspective may not be made. Finally, we need to be very careful not to create new incentives to maintain congestion and oppose new construction. Where a market participant funds a new line in exchange for rights to associated congestion revenues, that market participant may very well become an opponent of the next new line that would lessen congestion and therefore the value of the congestion revenue rights received by the first participant funder.

These problems strongly suggest that we need a regional transmission planning regime that includes a clear obligation on the part of RTOs to build or cause construction of the transmission necessary to ensure reliable service for customers and reasonable access to competitive regional markets. TAPS believes that RTOs should be obligated to construct, or cause the construction of, new facilities needed to maintain reliability, accommodate load growth (as utilities have in the past), enable RTOs to honor existing transmission rights, and provide all loads with reasonable access to the competitive market. RTOs also should be required to build, or cause construction of, major new inter-regional highway facilities and to integrate new generation into the regional grid. Assignment of costs of this integration should track cost causation and benefits.

Let me close by saying again that we are generally supportive of a uniform market structure for the U.S. electricity market. However, the details we have outlined here are vitally important if the market is actually going to work for the benefit of the end-use consumer. If SMD does not create a better market structure for IMEA, with our resources and experience in the power market, it will not work for customers in a retail choice

environment. We hope the commission will agree and take these matters up with the FERC.

Thank you again for inviting me to offer these remarks.